RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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October 3, 1984 **LETTER 897**

Sept. 21, DJIA 1201.74; PTI 1605; A-D Ratio –19.92
Sept. 28, DJIA 1206.71; PTI 1615; A-D Ratio –20.09

MARKET THOUGHTS: Question: What was the significance of the surge in the Averages from the July lows?

Answer: To my mind, the great significance of that surge was that it took the D-J Averages (Industrials and Transports) *far above* their July lows of 1086.57 and 444.03. Remember, for the primary trend to be reclassified as down, the Averages would now have to break below their July lows again. That would entail major drops by BOTH the Industrial and Transportation Averages. The odds on both of these Averages again breaking below the July lows are slim. I don't say it couldn't happen (anything can happen on Wall Street), but it's a large plus that the Averages (despite their August-September corrective moves) are still well above the July lows.

From a Dow Theory standpoint, as long as one or both Averages now hold above the July lows of 1086.57 and 444.03 (see page 1 chart) the trend will remain bullish.

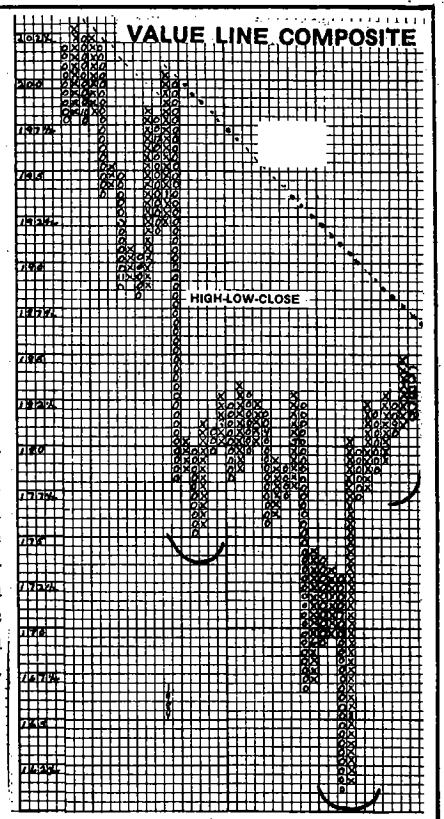
Question: Under Dow Theory why did you classify the surge from the July lows as signalling a bull market?

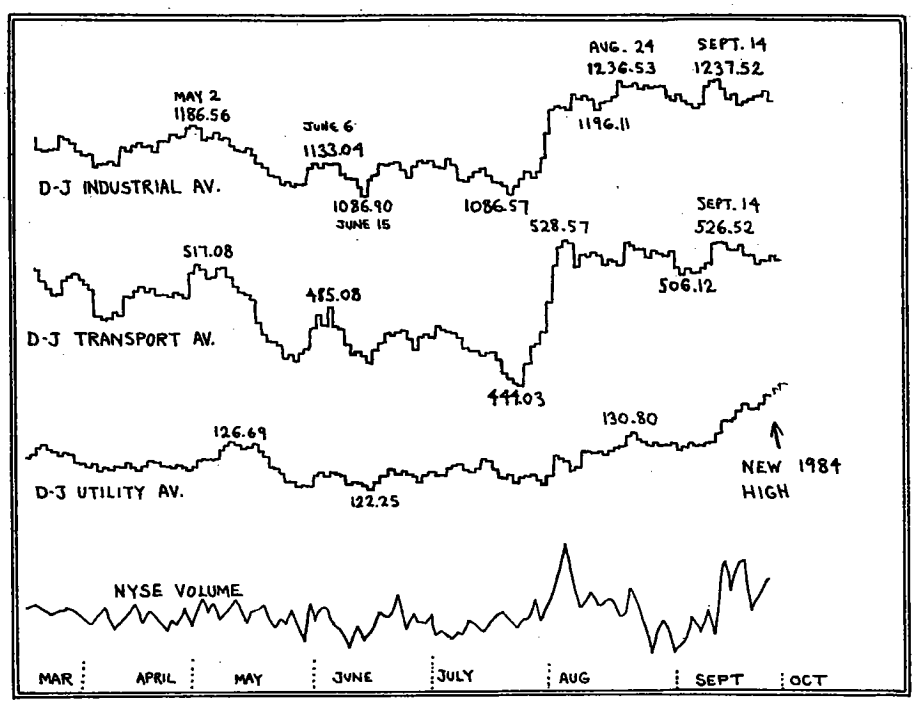
Answer: Robert Rhea (who formulated modern Dow Theory) stated that when the Averages hit bottom, then turn up and continue up through their last secondary peaks, it is reasonable to assume that the primary trend has turned bullish. I felt that the May 2 peaks were secondary peaks. When BOTH Industrials and Transports roared through the May 2 peaks on huge volume (remember, we saw three days of 9 to 1 upside volume), that move signalled a bull market. Later, in late-August, the Utility Average moved above its May 2 peak, and this constituted a further plus in the picture.

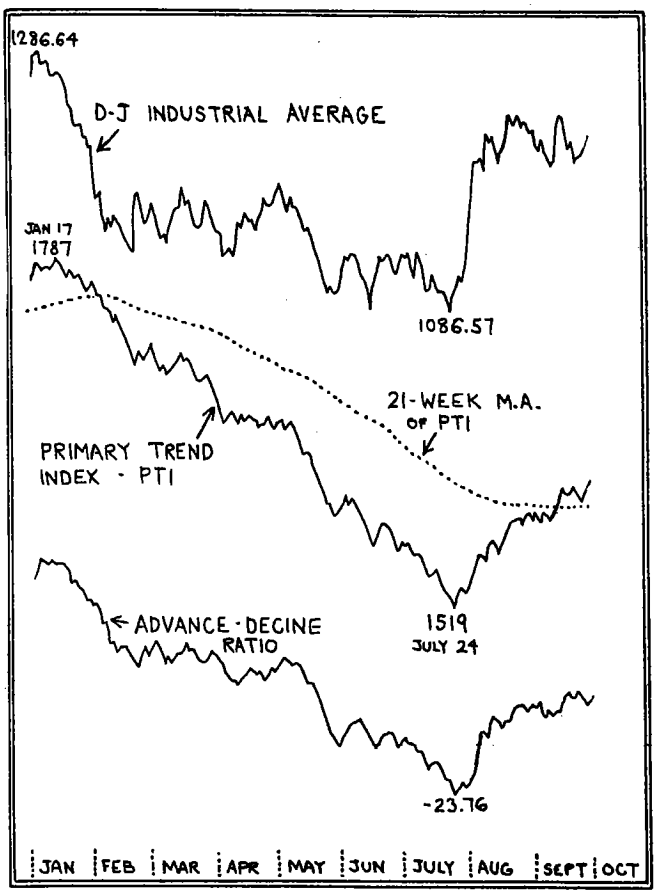
Question: Russell, I note that you mention the action of the Utility Average quite frequently, despite the fact that the Utility Average plays no part in the classic Dow Theory.

Answer: The D-J Utility Average only came into being during 1929, so neither Dow nor Hamilton had a chance to work with it. Rhea stated that the Utility Average could have important forecasting value, but he admitted that he did not have enough history to draw implications from it (Rhea died in 1939). E. George Schaefer (another great Dow Theorist) did monitor the Utility Average closely, and he felt that the Utilities (since they were sensitive to interest rates, electricity

KEY? I've been drawing attention to this point & figure chart of the Value Line Composite. Putting all other considerations aside, this is a powerful looking chart. And frankly, it doesn't jibe with all the worries and problems that we read about. In my experience, bottom formations as clear as this one usually work out. So let's watch the Value Line carefully. Any chart, of course, can abort. But this chart has the look of a massive base. The Value Line is one of the broadest stock indexes, so a bullish resolution here would obviously be bullish for the entire market.







consumption and the regulatory authorities) possessed lead characteristics. The Utility Average was of great help to Schaefer during the 1949 to 1966 bull market, and he continually referred to the new highs in the utility Average.

Question: Russell, in the last Letter you stated that you were more unwilling than ever to offer scenarios regarding what lies ahead for the stock market. Why are you being so cautious?

Answer: One of the reasons is that the background is so confusing. For instance, the September issue of the *Bank Credit Analyst* says, "prospects for strong economic growth remain intact." Yet the BCA's own debit/loan ratio, which tends to forecast corporate profits, is currently falling out of bed. Last week I received *Industry Forecast* by David and S. Jay Levy (and they possess a very good record). Say the Levys, "The profit margin squeeze in the first half of next year may well be among the worst that business has experienced since the Great Depression." The Levys do not make such statements lightly.

Question: But as a Dow Theorist and a market observer, I thought you accepted the stock market as ITS OWN best forecaster and also as the most trustworthy barometer of coming business trends.

Answer: That's correct, but like so many others in this business, I am forever trying to read between the lines.

Question: What are some of the plusses in the current picture?

Answer: One of the obvious plusses has been the strength in the bond market. Interest rates on long-term T-bonds have dropped from a recent high of 13.75% down to just above 12% today. The stock market obviously likes the lessened competition from bonds. And the fact is that the US has one of the world's strongest economies, and this, of course, accounts for a lot of the strength in the dollar.

Also in the background, we have the chance (I hope it's a probability) that Reagan and the Congress will do something drastic in terms of balancing the Federal budget once the election is over. In my opinion, the deficit situation is now so bad and the adverse publicity so devastating that we are nearing the point where Congress cannot avoid the problem much longer.

Question: Is it possible that the market, in its decline from mid-1983 to July 1984, has discounted a profit squeeze and even a recession in 1985?

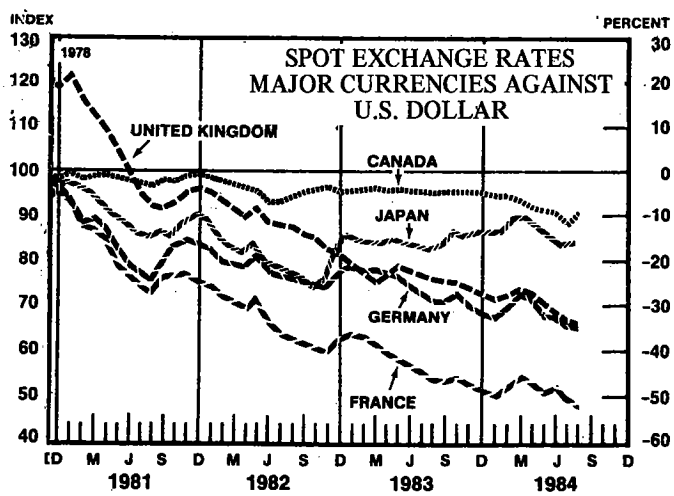
Answer: Historically, the stock market has discounted coming events anywhere from a few months to as much as a year ahead. So it is at least conceivable that the one year market decline (in terms of the advance-decline ratio) discounted trouble in 1985. But if major trouble lies ahead, the BEST I would expect would be testing of the July 1984 lows of 1086.57 (D-J Indutrials) and 444.03 (D-J Transports).

Question: What would it mean if those lows were broken?

Answer: If the 1984 lows are taken out, I would say that the action since August was simply a violent and deceptive bear market rally, a rally that had been aborted. In that case, the "continuing bear market" argument of Joe Granville, Julian Snyder and Donald Hoppe would have proven to be correct. And I would take my hat off to those gentlemen.

Question: Russell, what do you make of the balance-of payments deficits?

Answer: This is a hemorrhaging situation with record deficits coming through every month. The strong dollar has made the US the perfect selling ground for foreign goods. More than that, the flood of "bargain" foreign goods is making it impossible for US manufacturers to raise prices. Thus, a *squeeze on corporate earnings* is on. In the past few weeks, in fact, Merrill Lynch's analysts have been cutting 1984 estimates on about four companies for everyone they have been raising. The squeeze is also seen in the current corporate rush to cut costs, to hold the line on wage demands and in many cases to cut back on personnel. All of this could lead to a recession or at least recessionary tendencies during 1985.



Question: What happens when the dollar finally tops out?

Answer: This is a question that really worries me. Don't forget, foreigners have been financing a big chunk of the US deficits by

buying US debt instruments. Foreigners love US debt because its safe, it pays a high return, and the dollar is super-strong. But if the dollar tops out (and eventually it will) foreigners are going to rush to convert back to other stronger currencies. Such a shift will almost surely be violent, and the dollar could even crash when the turn comes (the kind of strength we've witnessed in the dollar doesn't usually give way to mild weakness at the turn). A dollar collapse could lead to horrendous problems for the Treasury and for the Fed. For that reason, I feel that the Fed really wants a strong dollar, and it will therefore fight against interest rates falling too far.

Question: So all in all, Russell, what's your view or your conclusion about events as they are shaping up?

Answer: I honestly don't have a scenario at this time. But I do have a few convictions. (1) One way or another taxes will be going up after the elections. (2) Defense spending (particularly in the new Strategic Defense area) will be skyrocketing far beyond what economists now estimate. (3) No tree grows to the sky, and in this case I'm referring to the dollar. It is heading for a top-out. But the "when" is still the mystery. (4) More and more I am leaning towards the view that the major economic trend is deflationary. Latest item to hit the deflation train is California farmland (see WSJ, Sept. 21). Farm prices are sagging and price of farmland here is crumbling. (5) I think the banks are moving towards a posture of much more stringency in loans. There's nothing like fear to make a bank pull in its horns–and the banks are fearful (on oil loans, farm loans, international loans).

So. . .more than ever I am going to depend on the stock market to tell me its own story. The Primary Trend Index has been of great help to me during the 1984 year. And the PTI has been in a bull trend ever since late-July.

One thing that bothers me a bit now. The PTI has been pushing to new highs, but the Averages have not yet confirmed. Judging from past experience, I know that if too long a time elapses without a confirmation from the Averages, it is a negative sign. What it means is this: it takes a good deal of all-around technical market strength to push the PTI to new recovery highs. If the Averages, in the face of new PTI highs, persistently refuse to confirm, this means that the technical strength has been dissipated without getting the job done.

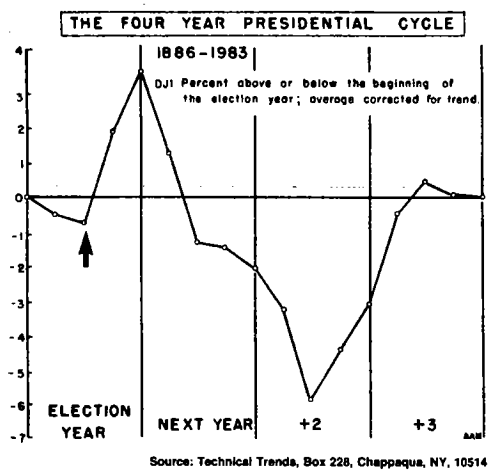
I definitely like the fact that the Utility Average has been pushing to new 1984 highs (see chart on page 1). But to reconfirm the bull market, I would like to see the D-J Industrials Average better its 1236.53 peak confirmed with a Transport bettering of 528.57. If the Averages stubbornly refuse to better those highs, we are going to face a correction.

Question: What about the electon year pattern? Is it going to work through the end of this year and into 1985?

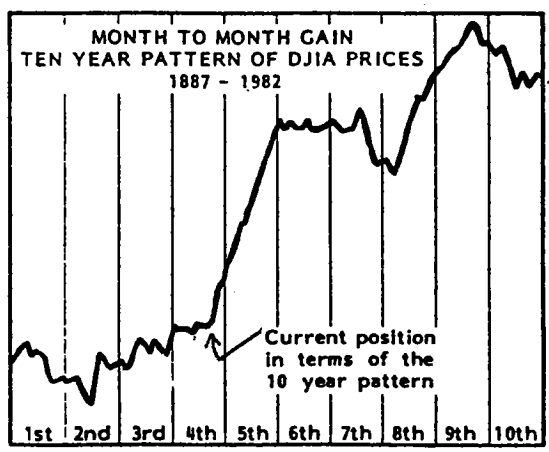
Answer: I don't like cliche scenarios or pat answers. The chart shown here is widely recognized in the investment business (chart courtesy of Merrill Analysis, Box 228 Chappaqua, NY 10514). Here we see the "normal" up-move during the second half of the election year the "normal" big slide during the year following the election.

But against this there's the decennial pattern which deals with each year during the ten year cycle (for instance, the 3-years such as 1913, 1923, 1933, 1943). It is a strange truism, but there does seem to be a tendency towards a decennial pattern in the stock market. The 5-years have historically been the STRONGEST years of the decennial pattern. In fact, since the turn of the century we have NEVER had a down 5-year.

The dilemma then, is that in 1985 the after-election year cycle runs head-on into the 5-year decennial cycle. So what will 1985 be–up or down? My own guess–we'll witness a rather frustrating and volatile 1985 with the market by year-end not showing any big net change. But there will be lots of action. In which case high-grade, high yielding stocks, 5-7 year T-notes and T-bills will be the best places to be.



Source: Technical Trends, Box 228, Chappaqua, NY, 10514



Source: Growth Fund Guide, Rapid City, SD

INVESTMENT POSITION: The bull will reside in this box as long as the PTI is above its 21-week moving average. The real play in this market so far is the one that I have liked best–bonds. The long-term Treasury bonds are now up 17%. When you add a yield near the lows of over 13.5%, you're talking 30% total return since June.

It bothers me a bit that the Averages have not confirmed the stronger PTI (I noted this before). It also bothers me a bit that the PTI has climbed above its 21-week MA and then hesitated. Note also on the page 2 chart that the A-D ratio has also not confirmed the strength of the PTI. All in all, I would say that some caution is warranted here. Bonds continue to look stronger than stocks, but even in the bond market a correction is way overdue.

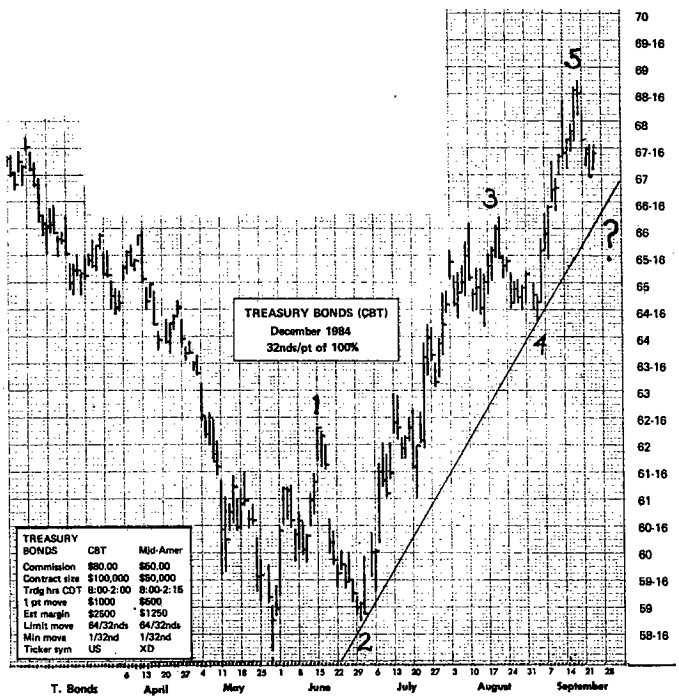
Two items are making me cautious here. The first is the *Bank Credit Analyst*'s debit/loan ratio, which has been falling precipitously. This ratio tends to reflect coming trends in corporate profits. The second is the comments coming out of the Levys' *Industry Forecasts*. In a report received today these gentlemen

from Chappaqua, NY have written the strongest warning I have ever seen them issue. The report commences with the title "Grim Recession Begins." They wind up the report with this: "Profits by any definition, are falling in the third quarter. The pace of the decline will accelerate. The worst business recession since the 1930's lies ahead." The Levys be it noted, are not given to exaggeration or cries of "Wolf."

From my own standpoint, I am stating now that if the PTI breaks below its 21-week MA, I will be issuing a sell signal.

BONDS, MONEY RATES: The long term T-bond market pretty much sets long-term rates. Consequently, in this age of towering deficits and tottering debts, the eyes of the world are always riveted on the T-bond market.

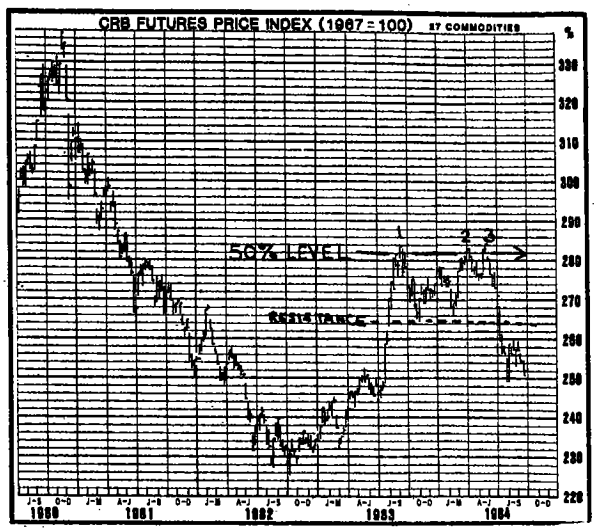
I don't always make great calls, but I made a good one here (see Letters 889 and 890). The bonds have moved into leg 5 of an Elliott bull move. In super-powerful bull markets the 5 leg can extend into a new 1-2-3-4-5 structure. Or the 5 leg can end the



rise—at least temporarily. My own instinct is to sit with the bonds and bond futures as we got in early, and there should be strong support at the 65-66 level (basis Dec. contract). This daily chart by Dunn & Hargitt pretty much tells the story in bonds. So far, it's been a nice ride. And it's been one of the main forces behind the stock market's rise.

DEFLATION? Some of the weakness in commodities can be accounted for by the strong dollar. But hardly all of it. Here's the widely-followed CRB Futures Index consisting of 27 different commodities (including silver but not gold). My interpretation of this chart is that the commodity picture is "on the edge."

First we saw the crash from the 1980 high to the 1982 low. Then the "triple-headed" rally to the 1983-84 high of 288. Note that on all three occasions the Index was turned back. This failure to recoup better than half of the 1980-82 losses was bearish under the 50% Principle.



Then during June-July the CRB Index smashed below the downside resistance at 265. Currently the Index is hovering just above 250, the 1984 low. I feel that any decisive crack below 250 will send the CRB Index down to test the 1982 low. Actually, at the current reading of 252 the CRB Index has given up a little more than half of its 1982-84 rally gains. And that's not good. A smash below 250 would spell deflation.

NOTES & QUOTES: Defense: A lot of people are "debating" the wisdom of a Star Wars defense. It has nothing to do with wisdom, it has to do with survival. And there's no debate in the military—it's happening. The Russiams are going full blast into space, and we're about to do the same. Those who argue against a US space defense are living in lotus-land. If we allow the Russians to dominate in space, we're ceding the world to them. Here's a clip that should bring my readers up to date:

LONDON (AP)—Space weapons will transform superpower defense strategies the way that the nuclear bomb did after World War II, and the Soviets are ahead in the race, according to the new Jane's Spaceflight Directory, published Tuesday.

Editor Reginald Turnill wrote that, although the United States "is undoubtedly well ahead in space technology," the Soviets have applied their technology of space stations armed with laser weapons more successfully.

Continuing U.S. Lag

"As a result, the United States cannot hope to catch up with the Soviet Union in space station operations" until well into the 1990s, he said in the introduction to the latest volume in the Jane's collection, esteemed in military circles for its expertness in weapons systems.

The United States is training military astronauts to man spacewar platforms because its generals fear that a superpower contest in space is "almost inevitable," Turnill wrote. He noted "growing concern about the increase in military space activities."

In an interview Tuesday with the British Broadcasting Corp., Turnill said that that meant fierce superpower competition rather than space battles. "The feeling is that contests, rather than war, are likely," he said.

* *

Tax Reform: You think tax reform is on the way? Don't bet more than a nickel on it. As I've been saying for months, there are whole industries based on keeping today's complex, screwball tax system. There are the accountants, the tax lawyers, the tax shelter boys, the IRS army, the tax preparation firms, on and on. The easiest way to raise big money is the VAT, and I feel it's coming. This little clip from the Sept. 28 LA Times gives you a vision of things to come.

WASHINGTON—To judge from the yawns of the few persons in the cavernous House Ways and Means Committee hearing room this week, tax reform advocates have not yet aroused much interest in their cause or convinced many insiders that the current income tax system is about to be fundamentally changed.

Even Washington's huge contingent of $200-an-hour tax lawyers and lobbyists—who usually turn out in droves for almost any tax session—largely ignored the hearings, apparently in the belief that their clients' treasured loopholes are safe.

The three days of testimony by more than a dozen tax reform experts had been billed as the key committee's first major effort to examine the advantages of a comprehensive tax overhaul.

Committee Chairman Dan Rostenkowski (D-Ill.) opened the hearings Tuesday by endorsing the idea of simplifying the tax code. But both Rostenkowski and Rep. Barber B. Conable Jr. of New York, the panel's ranking Republican, expressed skepticism about most of the tax reform proposals offered.

"The current system is intolerable and getting worse," declared one witness, Hugh Calkins, chairman of a recent American Bar Assn. tax committee. "The income tax is widely perceived as unfair and in need of broad-based reform."

But Conable, who at one point cautioned against "charging blindly forth" on tax restructuring, was quick to defend the complex income tax system against attack. Arguing that any overall reform soon would be undermined by demands for equally complex clarifications, exceptions and incentives, he warned against promising voters that Congress can eliminate most of the special provisions now in the tax code.

"Politicians can deal in perceptions," Conable said, "but as legislators we must deal in realities."

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When my good friend R.E. McMasters (he writes the commodity letter, "The Reaper") started telling me about his Llamas a few years ago I put it down to the strain of writing about commodities. Besides, red heads in this business are often a bit daffy. But to my shock and chargrin, it turns out that Llamas (yes, they look like hairy mini-camels) are the hottest thing around along with Honda Sprints and Michael Jackson records. R.E. told me that his herd of Llamas put out something like one male and nine female baby Llamas this year with the males selling for a grand and the females selling for six grand. Latest word: R.E. is sold out of baby Llamas for 1984. "What do you do with Llamas?" I asked R.E. "They're beautiful," he replied, "You just look at them and pet them."

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San Diego Update: Good news-bad news Dept. For the first time in its 16 year franchise history, the San Diego Padres have won the National League Western Division title. During the same week San Diego's youthful mayor, Roger Hedgecock, was indicted by the grand jury on 15 assorted counts of perjury and conspiracy.

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In an article entitled "How Good Are Wall Street's Security Analysts" Fortune magazine comes up with mixed reviews. One study shows that on estimates of corporate earnings one year ahead, the average error by analysts was 31%. But average earning estimate errors vary from industry to industry. For instance the Tobacco group is easiest to deal with and errors here are only in the 1.3% range. But banks outside New York showed a 40.2% error while crude oil producers showed a 42.1% error. Another major problem–just because an analyst hits an earnings projection on the head does not mean that he can tell where the stock is going. Biggest problem: an analyst can be dead right on a given stock's earnings but the market can make a fool of him. The reasons: the vast majority of stocks tend to move WITH the market, regardless of any individual stock's earnings.

Ah Ronald, your bark may be worse than your bite (but hopefully, your second term will be better). Despite all the whining about spending, it turns out that President Reagan has exercised FEWER vetoes than almost any other President in modern history. And, of course, Reagan keeps blaming Congress for passing spending bills. But Reagan could veto them. Here's the record of the Reagan vetoes compared with every President including Roosevelt. Read it and weep:

THE VETO'S HISTORY

Period	*President*	*Total Vetoes*	*Vetoes Per Year*	*Vetoes Sustained (%)*
1933-45	Roosevelt	635	52	99
1945-53	Truman	250	32	95
1953-61	Eisenhower	181	23	99
1961-63	Kennedy	21	7	100
1963-69	Johnson	30	6	100
1969-74	Nixon	42	8	86
1974-77	Ford	72	29	83
1977-81	Carter	31	8	94
1981-84	Reagan	23	7	83

Source: "Statistical Abstract of the United States, 1984"; Clerk of the White House.
Note: Where appropriate, the fact that a president served less than a full term is taken account of in the vetoes-per-year calculation.

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After a quarter of a century of boasting the virtues of jet engines, General Electric is extolling the marvels of a prop jetlines that will be out in the early 1990's. GE says that this new prop engine (called an "unducted propfan") will use 40% to 60% LESS fuel than today's turbofan jet engines.

* *

The Money Advocate (4180 W. B'way, Mpls. MN 55422) interviewed J. Peter Grace, whose task force turned out a 20,000 page thesis on how the US government could save money. Grace maintains that the US could save $424 billion over three years without damaging our military strength. You know something–I believe it. Items: the Farmers Home Administration makes 70% of its loans to non-farmers (delinquency rate on the non-farmer loans is 26%) . Hospitals built by the government cost twice as much as private hospitals. The federal retirement system has a $1 trillion liability that does not appear on the books at all.

How about computers? Listen to Mr. Grace on the government's information gathering system

> **The government has 332 incompatible accounting systems and 17,000 computers that don't communicate with each other. Plus, they're spending $1 billion over three years to have repair people on the government payroll because the manufacturers no longer have the expertise to keep these old computers running. If this thing is allowed to go on, it's going to cause an absolute information gap of the highest order. And once people start losing confidence in the situation, the government won't be able to float bonds.**

And here's Grace on what will happen if the US doesn't get it's deficits under control.

> **MR. GRACE: I can't say when this ball game is going to stop. When I was chairman of Mayor Beame's advisory committee in New York City, we were making all kinds of two-year projections. Then, one day, after getting off a plane in Memphis, I was told that the banks were not going to roll over New**

York City's debt the next morning. They said, "You better tell that to your friend the mayor." I said, "Well, give me a memo." I got back that night at ten o'clock and was handed a 175-page memo on the city's finances. I cut it down to twenty pages and went to see Mayor Beame the next morning. I told him that since the $6.2 billion in short-term debt wasn't being rolled over, the ball game was over. Then, at the last minute, New York state stepped in to help, financing with Big Mac bonds based on New York state's credit. Who is the big brother for Uncle Sam?

But nobody knows when these things are going to happen. There was no forewarning that the banks weren't going to roll over this debt. They just suddenly said, "We're not rolling it over."

* *

Being a read-a-holic sometimes pays off. Yes, I even read the letters to the editor sections. In the October 1 issue of Fortune, I found this gem. I thought it was worth including, just in case you missed it.

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Argentina's Woes

Re "The Argentinian Web Trapping U.S. Lenders" (August 20): The disaster began when the Videla government took office in 1976 and appointed Martinez de Hoz as economic minister. He and his team had more power for six years than anyone. Martinez de Hoz was referred to as Martinez de Whiz, and the team had almost unanimous support of all parties in Argentina and in the U.S. I heard Citibank Chairman Walter Wriston introduce Martinez as "the savior of Argentina" and heard much the same from Chase Chairman David Rockefeller and Manufacturers Hanover Chairman John McGillicuddy.

Martinez de Hoz and his team, who came from the wealthy agricultural sector, claimed that they wanted to make the Argentine industry "efficient." But they set an artificial value on the peso, which made it impossible for Argentine industry to export, and then opened the door to unlimited imports. So Argentine industry could not sell abroad and could not sell at home. Companies closed their factories and became importers.

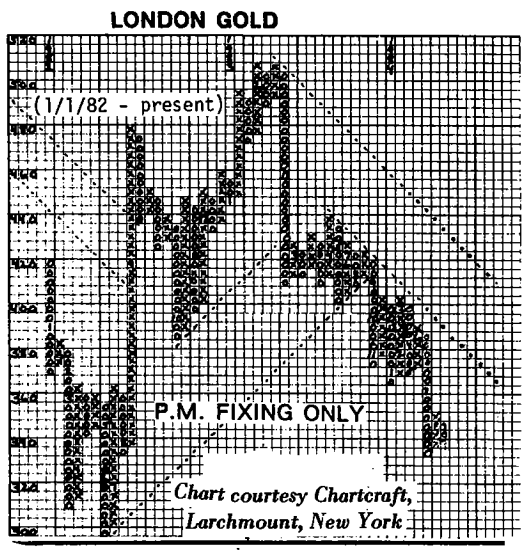
The U.S. banks were major contributors to this whole episode, because they wanted a Martinez de Hoz-led country and loaned money to perpetuate him in power. No prudent banker would increase a national debt from $7 billion to $44 billion. And little of that money went into constructive projects for the future. Most of it went into grandiose projects or loans to state entities with poor balance sheets—or perhaps to Switzerland.

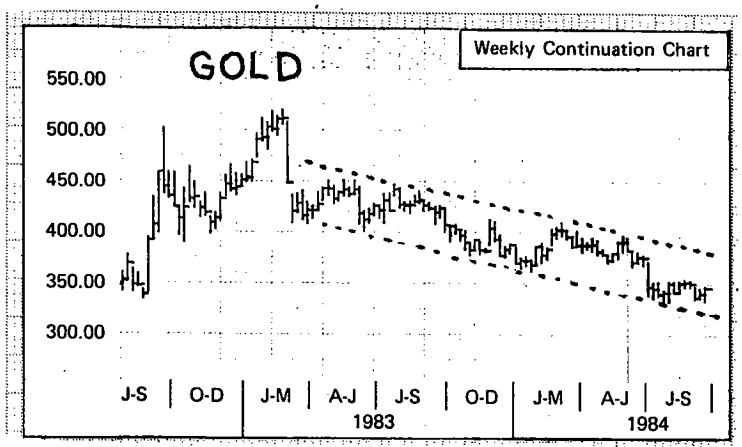
LAURENCE W. LEVINE
Walsh & Levine
New York City

GOLD: How expensive is it to be wrong on the primary trend? Let's see, suppose you had held $10,000 of gold near the high in 1980, then ridden it down to the present. You would have lost roughly 58% of your money in the ride down to the current $350. Now instead of riding gold down, suppose you had sold out near the high at say $750 and put that money into muni bonds from your own state at an average yield of 9%. In the four years since 1980 your $7500 would have grown to $10,582, thus, instead of $3,500 worth of gold, you would now have $10,582 worth of muni bonds. Quite a difference, but as they say, it's only money.

Bringing the picture to the present, gold bulls are impressed by the fact that gold has failed to smash through the 332.50 July low–even as the major currencies were in a state of collapse. Conversely, gold bears are saying that if the crashing pound and the slumping Swiss franc and German mark won't move gold up, what the hell will? I continue neutral. There's nothing in the gold picture (yet) that makes me want to buy the yellow metal. My gold-to-common stock ratio is still in the bearish mode for gold, and history tells me that this ratio should turn bullish (for gold) before I move into the metal.

I think it's almost a consensus among goldphiles that when the dolllar breaks gold will take off. They may be right, but I will wait patiently for the dollar to break. By the way, I don't know how many hundreds of millions have been lost speculating against the dollar over the last few years, but the figure must be enormous. As William Hamilton once wrote, "The graveyards of Wall Street are filled with the corpses of those who were right too soon."





NEXT MAILING: October 17

LATE NOTES: The nearby first line of defense for this market is the 1197.99 Industrial low and the 507.30 Transport low. If those lows are jointly broken, the July lows will almost surely be tested. The PTI remains bullish, and the Value Line Composite holds the hope that a major base has been formed. Also positive: The advance-decline line of the most-active stocks (NYSE) hit a new high last week, suggesting accumulation by large interests. The annualized short interest ratio (computed by Market Logic of Ft. Lauderdale, Fla.) recorded a whopping high of 2.50 last month.